EX PARTE OR LATE FILED

KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.

1301 K STREET, N.W.
SUITE 1000 WEST
WASHINGTON, D.C. 20005-3317

(202) 326-7900
FACSIMILE:
(202) 326-7999

MICHAEL K. KELLOGG
PETER W. HUBER
MARK C. HANSEN
K. CHRIS TODD
MARK L. EVANS
AUSTIN C. SCHLICK
STEVEN F. BENZ
NEIL M. GORSUCH
GEOFFREY M. KLINEBERG
REID M. FIGEL
HENK BRANDS
SEAN A. LEV

1 COMMERCE SQUARE
2005 MARKET STREET
SUITE 2340
PHILADELPHIA, PA 19103
(215) 864-7270
FACSIMILE: (215) 864-7280

January 21, 1999

RECEIVED

JAN 21 1999

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ex Parte Filing

Ms. Magalie Salas, Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
12th Street Lobby, Room TW-A325
Washington, D.C. 20554

In re Matter of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, **CC Docket No. 96-128**

Dear Ms. Salas:

On January 20, 1999, I met with Chairman William Kennard and Thomas Power on behalf of the RBOC/GTE/SNET Payphone Coalition to discuss issues in the above-captioned proceeding. The content of the discussion is covered in the attached ex parte presentation.

One original and one copy of this letter (along with the attachment) are being submitted to you in compliance with 47 C.F.R. § 1.1206(a)(2) to be included in the record of this proceeding. If you have any questions concerning this matter, please contact me at (202) 326-7902.

Sincerely,

Michael Kellogg

Michael K. Kellogg

No. of Copies rec'd 0+1
List ABCDE

RBOC/GTE/SNET PAYPHONE COALITION

January 1999

Payphones Prior to the 1996 Act

- LEC payphones still treated as part of regulated local exchange network.
  - Computer II (1980) excluded coin-operated payphones from definition of deregulated CPE

- Payphones did not receive fair compensation on most calls.
  - Most states kept local coin rates artificially low
  - RBOCs precluded from negotiating commissions on 0+ calls
  - Telephone Operator Consumer Services Improvement Act ("TOCSIA") (1990) eliminated IXC incentives to negotiate commissions on dial-around and access code calls

- LEC payphones subsidized by federal access charges and, in some cases, also by state access charges.

- Coin Registration Order (1984) recognized right of non-LEC providers to interconnect smart payphones with the public switched network.

  But competition limited by:
  - lack of fair compensation on many calls
  - subsidies for LEC payphones

Section 276 of the 1996 Act

Overarching Goals: To "promote competition among payphone service providers and promote the widespread deployment of payphone services to the benefit of the general public."

- Commission must ensure removal of all payphone access charge subsidies.

- Commission must ensure payphone service providers "are fairly compensated for each and every completed intrastate and interstate call using their payphones."

- BOC PSPs are to have the same right as independent PSPs to negotiate, select, and contract with IXCs for the carriage of 0+ traffic.

First Report and Order (Sept. 1996)

"Full and unfettered" competition is the best way to achieve Congress' overarching goals. Report and Order, 11 FCC Rcd at 20369, ¶ 55.

- LEC payphone assets to be reclassified as unregulated CPE; subsidies to terminate by April 15, 1997. Id. at 20633, ¶ 183.

- Fair compensation is market-based compensation:
  - Deregulation of local coin rate by October 1997. Id. at 20572, ¶ 60.
  - PSPs may negotiate compensation on 0+ calls. Id. at 20661, ¶ 240.
  - IXCs must track all dial-around and 800 calls and pay compensation. Id. at 20586, ¶ 86.

- BOC PSPs authorized to negotiate, select, and contract with IXCs for the carriage of traffic, subject to existing IXC contracts with location providers. Id. at 20661, ¶ 240.

First Report and Order: Per-Call Compensation

- Commission rejects cost-based approach to determining per-call compensation. Report and Order, 11 FCC Rcd at 20576, ¶ 68.
  - Commission chooses not to burden competitive payphone industry with cost-based rate-making proceeding. Order on Recon., 11 FCC Rcd at 21266, ¶ 66.
  - Commission recognizes that cost-based rate would reduce deployment of payphones in high-cost and low volume locations, contrary to the intent of Congress. Id. at 21267, ¶ 66.

- Default rate to be based on local coin rate as market-based surrogate. Report and Order, 11 FCC Rcd at 20577, ¶ 70.
  - Local coin rate is determined competitively. Id. at 20578, ¶ 72.
  - IXCs have "substantial leverage" to negotiate lower per-call rates because of their call-blocking capability. Order on Recon., 11 FCC Rcd at 21269, ¶ 71.

- Interim compensation to be based on default rate.
  - IXCs to pay interim compensation of $45.85 (131 calls originated from average payphone multiplied by $0.35) for one year. Report and Order, 11 FCC Rcd at 20604, ¶ 125.
  - IXCs to pay interim compensation at a negotiated rate or at the default rate of $0.35 for each compensable call for the following year. Id. at 20578, ¶ 72.

The Commission's Original Order Largely Upheld on Review

- D.C. Circuit approved deregulation of the local coin rate.
  - "A market-based approach is as much a compensation scheme as a rate-setting approach." Illinois Public Telecomm. Ass'n, 117 F.3d 555, 563 (D.C. Cir. 1997).
  - "[I]t was not unreasonable for the Commission to conclude that market forces generally will keep prices at a reasonable level." Id. at 562.

- Court upheld "carrier pays" and IXC tracking requirement; Court agreed that IXCs can "block" calls and negotiate a lower rate. Id. at 564, 566-67.

- Court found no fault with Commission's decision to reject cost-based methodology in determining per-call compensation. Cf. id. at 563.

- But Court rejected decision to set default rate equal to deregulated local coin rate.
  - Commission had stated that "cost[s] of originating the various types of payphone calls are similar." Report and Order, 11 FCC Rcd at 20577, ¶ 70, but the record contained evidence that costs are not similar. The Commission was required on remand to consider these alleged cost differences.

Second Report and Order (Oct. 1997)

- Avoided Cost Pricing Bases Per-Call Rate on Market Price:
  - Market forces will produce better service, lower costs, widespread deployment.
  - Market price *is* the "fair" price: "[T]he PSP will be providing a competitive service (payphone use) and should therefore receive compensation equal to the market-determined rate for providing this service." Recon. Order, 11 FCC Rcd at 21267, ¶ 68.

- Avoided Cost Pricing Starts with the Competitive Local Coin Rate:
  - Payphone market has "low entry and exit barriers" and "market will determine the fair compensation rate for [local coin] calls." Report and Order, 11 FCC Rcd 20577, ¶ 70.

- Avoided Cost Pricing Adjusts for Differences in Costs:
  - "We . . . reduc[e] the market-based local coin rate to reflect coin-related costs and increas[e] the market-based local coin rate to reflect costs that are related to [coinless] calls." Second Report and Order ¶ 26.
  - Addresses the Court's sole criticism of the First Report and Order.
  - Ensures that "each call placed at a payphone . . . bear[s] an equal share of joint and common costs." Id. ¶ 42.

<u>Payphone II</u> Remand: A Call for a Better Explanation

- The Court <u>did not</u> reject a market-based approach to per-call compensation:
  - "In principle, a market-based rate – as opposed to a cost-based rate – could satisfy the statutory fair compensation requirement."
- Nor did the Court reject the Commission's Avoided Cost methodology, but held that the Commission had failed to explain itself adequately.
  - Why is the local coin rate the proper starting point for deriving a price for coinless calls?
  - Why does it make sense to subtract costs (apples) from a market price (oranges)?
- The Court did not vacate the per-call compensation rate, but merely remanded for a better explanation.
- The Court called for Commission action by January 8, 1999.

Avoided Cost Pricing Is Theoretically Sound

- Avoided Cost pricing is a valid regulatory technique for determining the price that the market would set for a product where the market cannot function directly because of regulatory barriers.
  - Under an avoided cost approach, the market-determined price for one service is used as a starting point for deriving the regulated rate for another service. Costs unique to the service for which a market exists are subtracted from the market price; costs unique to the other service are added to the market price. The resulting rate thus ensures that the facility owner will earn the same economic return from each service.
  - Several economists, including Nobel Prize winner Gary Becker, Alfred Kahn, Jerry Hausman, and John Haring, have attested to the sound economic basis for the avoided cost pricing methodology.
  - Even opponents' economists – including William Baumol – have conceded that the avoided cost approach is theoretically valid.
- Avoided Cost pricing is efficient, because it ensures that the rates for payphone services reflect the costs of those services; it mirrors the results of a competitive market.
- Avoided Cost pricing is fair, because it ensures that each call will make an equal contribution to the joint and common costs of the payphone, and because the opportunity costs for the PSP will be the same for each type of call.

The Local Coin Market Is an Appropriate Surrogate For the Coinless Market

- The local coin market and the market for coinless calling are related in the relevant way – on the supply side – because all types of calls make use of the same payphone.

- The local coin market is highly competitive – as the Commission has already found – and the evidence supports the conclusion that costs and rates converge in this market.

  - low barriers to entry; IPSP market share has increased since deregulation

  - 10 years of experience with deregulated local coin rate in some states

  - data show that elasticity of demand for local coin calls is well below 1, indicating that the market price is competitive (a monopolist would set the price where elasticity is greater than 1)

  - D.C. Circuit: "it was not unreasonable for the Commission to conclude that market forces generally will keep prices at a reasonable level" (i.e., at the level of costs). 117 F.3d at 562.

The Objections to the Commission's Approach Are Misguided

1. "Locational Monopolies"
   - Already rejected by Commission in context of deregulating the local coin rate; affirmed by D.C. Circuit
   - Empirically unsupported:
     - opponents cannot point to a single example
     - Commission has invited states to identify problem areas; none has
   - Claim that every payphone is a monopoly is completely implausible
     - many competing payphones within sight of one another; others around corner or outside door
     - evidence shows constraining effect on price of competing payphones
     - elasticity of demand proves that price is set in competitive market

2. "Payphones Don't Accept Pennies"
   - Many markets have prices that are rounded off; doesn't mean they aren't competitive; supply adjusts incrementally to incremental changes in price.
   - No one can justify claim that round to nearest nickel would, on average be up, rather than down

3. "Chooser Isn't the Payor on Subscriber 800 Calls"
   - So long as local coin market is effectively competitive, per-call rate will be held to reasonable level
   - 800 subscribers have option not to accept 800 calls from payphones; it's a marketing decision.

Calling Party Pays Is No Solution

- The Commission rightly rejected a calling party pays compensation mechanism.
  - TOCSIA bars calling party pays for access code calls. 47 U.S.C. § 226(e)(2); First Report and Order, 11 FCC Rcd at 20585, ¶ 85.
  - Because payphones cannot distinguish between 800 access codes and subscriber 800 numbers, this effectively prevents implementation of calling party pays for all coinless calls.
  - Calling Party Pays would inconvenience consumers and increase transaction costs. Order on Recon., 11 FCC Rcd at 21275, ¶ 87.
- The D.C. Circuit has endorsed the Commission's carrier-pays approach.

The Commission Should Continue to Reject Cost-Based Approaches

- "Fair compensation" is market-based compensation.
  - Cost-based approach would be a step back: re-regulatory, instead of deregulatory.
  - Cost-based approach is notoriously inaccurate and contentious.
  - Cost-based approach either ignores widely different actual costs (among PSPs and in different states) or creates an administrative nightmare.
  - Cost-based approach fails to support payphones that are competitively justified but that have below-average usage or above-average costs
  - Cost-based approach would have the Commission, rather than the market, determine the appropriate number of payphones.

The Commission Should Correct Flaws In the Second Report and Order

- Coin Mechanism Costs are Not Avoided Costs
  - But for the coin mechanism, the payphone would not exist. The coin mechanism benefits coin callers and coinless callers – as economists Alfred Kahn and Jerry Hausman attest.
  - Per-call costs are higher for a coinless phone than for a coin-capable phone; coin mechanism costs were overstated in any event.
- The Commission Improperly Ignored Bad Debt and Collection Costs.
  - PSPs currently collecting only about 70 cents on the dollar.

Any Reduction in the Per-Call Rate Will Reduce Payphone Deployment

- Payphones are a declining volume business, with increasing competition from wireless technologies and fierce competition among PSPs for a decreasing pool of calling minutes.

- Even at current per-call compensation rates, tens of thousands, if not hundreds of thousands, of LEC payphones nationwide are uneconomic

- IXCs are heavily promoting dial-around calling which is extraordinarily lucrative for IXCs; 0+ calling (which is relatively profitable for PSPs) has declined dramatically since 1991.

- Reduced payphone deployments hurts consumers (particularly low-income consumers), equipment manufacturers, operator service providers -- and PSPs themselves.

The Commission's Avoided Cost Approach Is Highly Conservative

- The Commission Failed to Account for Demand Differences
  - Competitive firms allocate larger share of joint and common costs to products for which demand is less elastic.
  - Demand for local coin calls is more elastic than demand for access code and subscriber 800 calls.
  - Per-call rate should therefore be higher than the local coin rate.
  - Expert analysis of demand conditions indicates that the per-call rate should be \$0.42 - \$0.43.
- The Commission Ignored Market Results
  - IXC payments to PSPs on collect and credit-card calls ("0+ calls") average between \$0.78 and \$1.33 per call.

The Commission Should Issue an Interim Compensation Order With All Possible Speed

- LECs removed hundreds of millions of dollars in federal and state payphone subsidies as of April 15, 1997.
- At $0.284 per call, IXCs owe LECs over $300 million in interim compensation.
- Commission must require prompt and full payment of interim compensation amounts.
- Interim Compensation Formula:
  - $0.284 x (131 + average of uncompensated 0+, 1+, and 0- calls), with additional compensation for BOC inmate calls